Current Federal Tax Developments

Week of February 25, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF FEBRUARY 25, 2019

Published in 2019 by Kaplan Financial Education.

Printed in the United States of America.

Current Federal Tax Developments

Kaplan Professional Education

Table of Contents

Section: State Tax
State Law Providing Exempton from State Taxation of State But Not Federal Law Enforcement Pensions Held to Illegally Discriminate Against Federal Employees

Citation: Dawson v. Steager, Case No. 17-419, US Supreme Court, 2/20/19

The U.S. Supreme Court found to be illegal a West Virginia state tax break that provided an exemption from state tax for retired state law enforcement employees but did not offer the same benefit to retired federal law enforcement employees. The Court unanimously ruled in the case of *Dawson v. Steager*, Case No. 17-419 that the West Virginia court was in error finding that the law was acceptable since it applied only to a narrow class of retirees and did not intend to discriminate against federal marshals.

Prior to the Court's decision in *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 810 (1989) many states had statutes that exempted retirement pay of state retirees from state tax, but did not provide such an exemption to federal retirees. However, the Court found that such laws violated 4 USC §111(a) which provides:

> *(a) General Rule.—*
>
> *The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.*

The Supreme ruled such broad laws violated the anti-discrimination provision of 4 USC §111(a) even though it discriminated against former rather than current employees.

Justice Gorsuch, writing for the Court, provided the following analysis of the anti-discrimination rule:

> *Section 111 codifies a legal doctrine almost as old as the Nation. In McCulloch v. Maryland, 4 Wheat. 316 (1819), this Court invoked the Constitution's Supremacy Clause to invalidate Maryland's effort to levy a tax on the Bank of the United States. Chief Justice Marshall explained that "the power to tax involves the power to destroy," and he reasoned that if States could tax the Bank they could "defeat" the federal legislative policy establishing it. Id., at 431–432. For the next few decades, this Court interpreted McCulloch "to bar most taxation by one sovereign of the employees of another." Davis v. Michigan Dept. of Treasury, 489 U.S. 803, 810 (1989). In time, though, the Court softened its stance and upheld neutral income taxes — those that treated federal and state employees with an even hand. See Helvering v. Gerhardt, 304 U.S. 405 (1938); Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939). So eventually the intergovernmental tax immunity doctrine came to be understood to bar only discriminatory taxes. It was this understanding that Congress "consciously . . . drew upon" when adopting §111 in 1939. Davis, 489 U.S., at 813.*

West Virginia justified its provision by arguing that its law applied only to a narrow class of employees, and that the duties of these individuals was substantially different from that of those employed in federal law enforcement. James Dawson, a retired U.S. Marshall, challenged the state's position, arguing that the law illegally discriminated against him by denying him the same tax deduction that he would have been allowed had he been a retired West Virginia law enforcement officer.

Justice Gorsuch described Mr. Dawson's journey through West Virginia's courts:

> *Mr. Dawson's own attempt to invoke §111 met with mixed success. A West Virginia trial court found it "undisputed" that "there are no significant differences between Mr. Dawson's powers and duties as a US Marshal and the powers and duties of the state and local law enforcement officers" that West Virginia exempts from income tax. App. to Pet. for Cert. 22a. In the trial court's judgment, the State's statute thus represented "precisely the type of favoritism" §111 prohibits. Id., at 23a. But the West Virginia Supreme Court of Appeals saw it differently. In reversing, the court emphasized that relatively few state employees receive the tax break denied Mr. Dawson. The court stressed, too, that the statute's "intent . . . was to give a benefit to a narrow class of state retirees," not to harm federal retirees. Id., at 15a.*

Mr. Dawson asked the Supreme Court to hear his appeal from the West Virginia Supreme Court and his request was granted. The U.S. Supreme Court held that "the state trial court had it right" and the West Virginia Supreme Court erred in overturning that result.

The State argued that even if its law favored some state law enforcement retirees over their federal counterparts, the favored class was a very small one. Most state retirees were in the same position as Mr. Dawson, not obtaining a subtraction from income for their retirement benefit. The U.S. Supreme Court was not impressed with this argument:

> *We are unpersuaded. Section 111 disallows any state tax that discriminates against a federal officer or employee — not just those that seem to us especially cumbersome. Nor are we inclined to accept West Virginia's invitation to adorn §111 with a new and judicially manufactured qualification that cannot be found in its text. In fact, we have already refused an almost identical request. In Davis, we rejected Michigan's suggestion that a discriminatory state income tax should be allowed to stand so long as it treats federal employees or retirees the same as "the vast majority of voters in the State." 489 U.S., at 815, n. 4. We rejected, too, any suggestion that a discriminatory tax is permissible so long as it "does not interfere with the Federal Government's ability to perform its governmental functions." Id., at 814. In fact, as long ago as McCulloch, Chief Justice Marshall warned against enmeshing courts in the "perplexing" business, "so unfit for the judicial department," of attempting to delineate "what degree of taxation is the legitimate use, and what degree may amount to the abuse of power." 4 Wheat., at 430.*

The Court noted that it would permissible for the state to exempt a narrow class of state employees if, at the same time, it offers the exemption to similarly situated federal employees. But the mere fact that a law discriminates against only a small number of individuals under 4 USC §111 does not render that law acceptable. Rather, the law must eliminate that discrimination.

The lack of an intent to "punish" federal retirees also cannot save the provision. As the opinion continues:

> *We can safely assume that discriminatory laws like West Virginia's are almost always enacted with the purpose of benefiting state employees rather than harming their federal counterparts. Yet that wasn't enough to save the state statutes in Davis, Barker, or Phillips, and it can't be enough here. Under §111 what matters isn't the intent lurking behind the law but whether the letter of the law "treat[s] those who deal with" the federal government "as well as it treats those with whom [the State] deals itself." Phillips Chemical Co., 361 U.S., at 385.*

The state argued that there was a significant enough difference between the federal law enforcement retirees and those state retirees granted West Virginia's exemption to justify the different treatment. But the Court found that was not the case, noting:

> *The state statute singles out for preferential treatment retirement plans associated with West Virginia police, firefighters, and deputy sheriffs. See W. Va. Code Ann. §11–21–12(c)(6) (Lexis 2017). The distinguishing characteristic of these plans is the nature of the jobs previously held by retirees who may participate in them; thus, a similarly situated federal retiree is someone who had similar job responsibilities to a state police officer, firefighter, or deputy sheriff. The state trial court correctly focused on this point of comparison and found no "significant differences" between Mr. Dawson's former job responsibilities as a U.S. Marshal and those of the state law enforcement retirees who qualify for the tax exemption. App. to Pet. for Cert. 22a. Nor did the West Virginia Supreme Court of Appeals upset this factual finding. So looking to how the State has chosen to define its favored class only seems to confirm that it has treated similarly situated persons differently because of the source of their compensation.*

The state argued that it could show there existed groups of state employees that were denied the exemption who were similarly situated to the federal law enforcement retirees. But the Supreme Court found that this issue wasn't relevant, stating:

> *Under §111, the relevant question isn't whether federal retirees are similarly situated to state retirees who don't receive a tax benefit; the relevant question is whether they are similarly situated to those who do. So, for example, in Phillips we compared the class of federal lessees with the favored class of state lessees, even though the State urged us to focus instead on the disfavored class of private lessees. 361 U.S., at 381–382. In Davis, we likewise rejected the State's effort to compare the class of federal retirees with state residents who did not benefit from the tax exemption rather than those who did. See 489 U.S., at 815, n. 4.*

The fact that the state's pensions were less generous than the federal pensions also did not justify this treatment. The opinion objects that the law does not impose a specific economic test for qualification:

> *The problem here is fundamental. While the State was free to draw whatever classifications it wished, the statute it enacted does not classify persons or groups based on the relative generosity of their pension benefits. Instead, it extends a special tax benefit to retirees who served as West Virginia police officers, firefighters, or deputy sheriffs — and it categorically denies that same benefit to retirees who served in similar federal law enforcement positions. Even if Mr. Dawson's pension turned out to be identical to a state law enforcement officer's pension, the law as written would deny him a tax exemption. West Virginia's law thus discriminates "because of the source of . . . compensation or pay" in violation of §111. Whether the unlawful classification found in the text of a statute might serve as some sort of proxy for a lawful classification hidden behind it is neither here nor there. No more than a beneficent legislative intent, an implicit but lawful distinction cannot save an express and unlawful one.*

Section: 119
Does Having UberEats in the Area Put Employer Provided Meals Into the Employee's Wages? The IRS Thinks It Does in Many Cases.

Citation: TAM 201903017, 2/15/19

The IRS indicated that the existence of expanded delivery options for meals in an area may eliminate the ability of an employer to claim that meals are provided to employees for the convenience of the employer in [TAM 201903017](). While the TAM deals with a number of issues in its 50 pages, the consideration of the impact of delivery services such as *UberEats* is something new in this area.

IRC §119(a)(1) provides for an exclusion for the value of meals provided to an employee by an employer under the following conditions:

> *(a) Meals and lodging furnished to employee, his spouse, and his dependents, pursuant to employment*
>
> *There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer for the convenience of the employer, but only if—*
>
> > *(1) in the case of meals, the meals are furnished on the business premises of the employer…*

Under IRC §119(b)(4) all meals furnished to employees will be excludable under this rule if over half of the employees to whom meals are furnished are furnished such meals for the convenience of the employer. That is, once the employer shows a "convenience of the employer" reason for more than one-half the employees to whom meals are furnished, the rest of the employees are simply deemed to receive such meals for the convenience of the employer.

Meals are generally deemed to be furnished for the convenience of the employer if provided for a substantial non-compensatory reason.[1] Reg. §1.119-1(a)(2)(ii) provides that the following would be examples of substantial non-compensatory reasons for providing the meals. Such reasons include the nature of the employer's business is such that the employee has a very limited time for lunch, and could not be expected to eat elsewhere in such a restricted period. Similarly, if there simply insufficient eating facilities in the area where the employee works to allow him/her to obtain a proper meal in a reasonable time period, that also would provide a substantial non-compensatory reason for providing the meals to the employee.

In *Boyd Gaming Corp. v. Commissioner,* 177 F.3d 1096 (CA9, 1999) the court ruled that the IRS was not allowed to second guess an employer's justification for any policies it adopted that might lead to employees being unable to obtain proper meals within a reasonable time period. But the policies must be reasonably related to the needs of the employer's business and are actually followed by the employer in his/her business.[2]

Key to the situations cited above is the lack of time or ability for the employee to obtain lunch off-site. But in this memorandum the IRS takes note of the rise of meal delivery services.

Until recently, delivery of meals was generally limited to a few types of restaurants and often working with highly restricted delivery. However recent years have seen the rapid development and growth of delivery services that will deliver meals from a large variety of restaurants on demand. Such services include *GrubHub, Seamless, DoorDash, Postmates* and *UberEats.* While not available everywhere, they are now available to a significant portion of the United States, particularly in urban and suburban areas.

---

[1] Reg. §1.119-1(a)(2)(i)

[2] AOD 1999-010, August 10, 1999

In this TAM, the IRS notes the impact of this change of circumstance on the analysis of the convenience of the employer test for IRC §119:

> *There is no specific discussion of meal delivery in section 119, related regulations, or in case law involving this provision. However, until relatively recently, meal delivery options were limited in availability. In the past several years, the proliferation of food delivery services, online ordering options, and mobile phone applications that provide delivery services has made meal delivery options much more abundant now than in the past. That the phenomenon of expanded delivery options is so recent may explain its absence from specific discussions of section 119. There is no discussion in section 119 case law of meal delivery options being available in any specific case, nor is there any statement that meal delivery options should not be considered in section 119 analysis.*

The IRS points out the existence of such services undermines the argument that the employee cannot obtain a meal in the time period available as a justification for the exclusion from the employee's wages:

> *…[I]f employees have a panoply of meal options that can be delivered to their place of work with just a phone call, through a website, or via a smart phone application, then the requirement in § 1.119-1(a)(2)(ii)(c), that without the employer-provided meals an employee cannot secure a proper meal within a reasonable period, is not met. There is nothing in this provision to indicate that the employee must be able to obtain the meal off business premises. Indeed, the availability of extensive delivery choices mean that the employee has more efficient meal options than a location with no delivery options but many restaurants nearby. By using a delivery service, the employee can continue to work while the food is being prepared and does not have to take time to travel to the eating facility location. Employees with access to abundant and varied meal delivery options are able to secure a proper meal within a reasonable period.*
>
> *While the availability of meal delivery is not determinative in every analysis concerning § 1.119-1(a)(2)(ii)(c), especially in situations where delivery options are limited, meal delivery should be a consideration in determining whether an employer qualifies under this regulation. In addition, meal delivery options should be considered when evaluating other business reasons proffered by employers as support for providing meals for the "convenience of the employer" under section 119, since in many cases the availability of meal delivery will affect the determination of whether employer-provided meals are necessary for employees to properly perform their duties.*

The TAM suggests the IRS may be looking at raising questions about all types of foods provided by employers for employees on site. Other sections of the TAM look into employer provided snacks and other issues related to such benefits provided to employees.

Section: 132
IRS Acquiesces in Result Only in Hockey Team Meals Case

Citation: Action on Decision AOD 2019-01, 2/15/19

Although the case arguably has been rendered effectively moot by the Tax Cuts and Jobs Act, the IRS did announce in Action on Decision AOD 2019-01 that it acquiesced in result only in the case of *Jacobs v. Commissioner*, 148 T.C. No. 24 (2017).

The *Jacobs* case, which we detailed when the case was originally released (*Full Deduction Allowed to Hockey Team for Meals Provided to Players at Away Games*, 6/20/17), held that a profession hockey team that provided meals for its players in areas leased from local hotels for away games qualified as meals provided at an employer's eating facility under §132(e). Based on the law in effect that time, such employer meals provided at an employer's eating facility qualified for a 100% deduction for the employer and no inclusion in income for the employee.

The Tax Cuts and Jobs Act moved to phase-out this deduction, providing for only a 50% allowance for years beginning after 2017 and reduced to 0% for amounts paid after December 31. 2025.[3]

As the AOD notes, an "acquiescence in result only" means:

> *Both "acquiescence" and "acquiescence in result only" mean that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. However, "acquiescence" indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions; whereas, "acquiescence in result only" indicates disagreement or concern with some or all of those reasons.*

Specifically, the IRS outlines the agency's position on this case as follows:

> *Acquiescence in result only as to whether a professional hockey team's expenses for providing pregame meals at away city hotels were fully deductible because they were provided at employer-operated facilities.*

Unfortunately, this is as much guidance as the IRS gives regarding what parts of the reasoning of the opinion the agency disagrees with. The AOD does serve as a caution to taxpayers and advisers that the agency is likely to challenge attempts to expand upon this ruling to cover other situations.

Section: 164
Owners of Shares in Housing Cooperatives May Escape $10,000 Limit on Tax Deduction Due to Drafting Error in TCJA

Citation: Bernie Becker, " Plugging opportunity," Politico Morning Tax, 2/21/19

In Politico's [Morning Tax](https://www.politico.com/newsletters/morning-tax/2019/02/21/plugging-opportunity-397663)[4] on February 21, 2019 a potential loophole regarding property taxes paid by owners of units in housing cooperatives is discussed. As the article notes:

> *So why might living in a co-op give taxpayers a way around the SALT cap? In short, co-op owners don't pay a property tax, or actually buy a property as it's usually understood, as Pro Tax's Brian Faler reported. That matters because lawmakers bypassed the section of the tax code that does allow co-op owners to deduct their version of property taxes — essentially a fee paid to the corporation that owns the property, which then pays the taxes — when drafting the TCJA.*

The article does caution it's "not apparent whether co-op owners can assume they're in the clear, at least for now, on property taxes." But what exactly is the issue?

To discover that, you must look at the tax law, specifically IRC §§216 and 164 and this thing called a housing cooperative (or co-op). Housing cooperatives are a form of ownership in

---

[3] IRC §274(o) as amended by the Tax Cuts and Jobs Act of 2017

[4] Bernie Becker, " Plugging opportunity," *Politico Morning Tax,* https://www.politico.com/newsletters/morning-tax/2019/02/21/plugging-opportunity-397663, February 21, 2019

residential units, often consisting of apartments in a single building. Their closest equivalent is a condominium development, but in the housing cooperative a corporation actually owns the building and residents own shares of stock in the corporation.

That share of stock gives the owner the right to occupy a specific unit, as well as access to the common areas. By contrast, condominium units are owned outright by the individual owner, and normally only the common areas are jointly owned and managed by the homeowner's association.

Recognizing that a co-op owner is similarly situated to the owner of a condominium unit, the IRC provides special rules that allow the co-op owner a deduction for taxes and interest even though he/she doesn't directly own residential property. These special rules are found at IRC §216.

Of specific interest in this issue is the grant of a deduction for amounts paid by the co-op as property taxes. IRC §216(a)(1) provides:

> *(a) Allowance of deduction In the case of a tenant-stockholder (as defined in subsection (b)(2)), there shall be allowed as a deduction amounts (not otherwise deductible) paid or accrued to a cooperative housing corporation within the taxable year, but only to the extent that such amounts represent the tenant-stockholder's proportionate share of—*
>
> > *(1) the real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation on the houses or apartment building and on the land on which such houses (or building) are situated,*

The potential problem arises based on how Congress limited to $10,000 an individual's deduction for income, sales and property taxes on personal property. IRC §164(b)(B) provides:

> *…the aggregate amount of taxes taken into account under paragraphs (1), (2), and (3) of subsection (a) and paragraph (5) of this subsection for any taxable year shall not exceed $10,000 ($5,000 in the case of a married individual filing a separate return).*

All of those references are internal to IRC §164 and the restriction is limited to individuals. However, this tax is taken into account under IRC §216 based on amounts paid by the corporation that are deductible to it under §164—and thus appears to not be subject to the $10,000 limit at the individual level by the wording of the provision.

The Joint Committee on Taxation, in their *General Explanation of Public Law 115-97* (the Blue Book) state that the intent of the law was to subject such payments to the $10,000 limit.

> *It is intended that the limitation apply to the deduction for amounts paid or accrued to a cooperative housing corporation by a tenant-stockholder under section 216(a)(1) (relating to real estate taxes) in the same manner as the limitation applies to real estate taxes under section 164.*[5]

[5] Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS-1-18, 2018, p. 68

However, a footnote to the above sentence indicates that while it may have been their intent, the law itself does not appear to accomplish that result:

> *A technical correction may be needed to achieve this result.*[6]

There is the possibility Treasury will decide that they can argue the language does accomplish that intent. It's less of a stretch than would have been required for the 15-year property retail glitch to have been fixed administratively (which Treasury decided they could not do), but it still appears to be a bit of a stretch due to the very specific cross-referencing in the limitation language. An attempt to achieve the intended result via an IRS administrative pronouncement or regulation could very well be challenged as being contrary to the unambiguous language of the statute.

If Treasury decides the agency can't fix the problem on its own, then Congress would have to pass a technical correction to achieve the desired result. But the cap on state and local taxes is politically controversial, and it may not be simple to get the language changed to reflect this intent through either the House or Senate at this point.

Advisers whose clients are thinking of taking this position on a return should disclose the position on Form 8275. The adviser should warn that client that while the position appears to meet the "reasonable basis" standard for taking the position on the return with adequate disclosure, the return will stand out with a large deduction on line 6, Schedule A (taxes not limited by $10,000 limit). As well, the IRS may try to shut this deduction down administratively and Congress may retroactively change this via a technical correction. But right now the law as written likely falls short of the author's intent to limit such deductions.

Section 199A
Can an LLC Operating a Shopping Center with Triple Net Leases for All Tenants Give Rise to Qualified Business Income?

Citation: Notice 2019-07, 1/18/19

This article is based on my response to a question raised on an online forum. The person asking the question recognized the issue, but because I've encountered some advisers who have come to believe the safe harbor is "the" test for rentals I wanted to clarify matters a bit. Hopefully this helps.

Facts: An LLC operates a shopping center with many tenants. While the leases are all triple net leases, the manager spends over 250 hours a year dealing with items related to the center, including collecting rents, paying the bills, finding new tenants, dealing with vendors and keeping the records of the operation. The operation doesn't qualify for the safe harbor of Notice 2017-07 due to being a set of triple net leases. Does that mean it cannot be a trade or business for Section 199A purposes?

---

[6] Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS-1-18, 2018, Footnote 294, p. 68

First, let's start with the important note that the safe harbor of Notice 2019-07 is just that--a safe harbor. So being unable to use the safe harbor or failing to meet the tests in the safe harbor does not mean you don't have a trade or business. It just means you have to look elsewhere to make this determination.

Triple net leases are a bit of a problem, but if you look at the cases the ones that have held a triple net lease situation is not a trade or business are rather distinct from what we are looking at as the owners normally had one lease and for the time in question just were collecting rent.. And, in a closely related determination under ERISA, the Seventh Circuit in *Central States Pension Fund v. Personnel, Inc.*, 974 F.2d 789 (7th Cir. 1992) found a trade or business when the other activities related to the triple-net leases were significant (the court specifically used the IRC Section 162 test for what was a trade or business).

The issue is to test under *Commissioner v. Groetzinger,* 480 U.S. 23 (1987) which is the key U.S. Supreme Court case on whether an undertaking rises to a trade or business. Under *Groetzinger* the test to see if you have a §162 trade or business is if the LLC can show:

- Its involvement (including that of its agents and members) is continuous and regular AND
- The primary purpose of running the center is income or profit

While a single triple net lease would have problems rising to that level (the involvement would generally not be continuous), this is far more than a single triple net lease--this is operation of a shopping center that requires a significant level of engagement by a manager to run the business.

Note that the test has to be whether the partnership (which the LLC is pretending to be under the IRC based on its check the box decision) meets the *Groetzinger* standard since RPE (relevant passthrough entities) are the level at which trade or business status is determined for any undertaking held directly by an RPE. If it does, it's a trade or business for all three partners. If it doesn't, it's not a trade or business with respect to any. This isn't like the passive activity rules--they all sink or swim together on this one.

I certainly think we have a very strong case this is a trade or business and, in fact, if it somehow showed a loss I think the IRS would have a strong case to force the members to recognize negative QBI (this can cut both ways, something often lost in the rental discussions I've seen to date).

I would certainly suggest that an adviser explain the justification, likely in a Form 8275, to stop an agent from going far down that rabbit hole in an exam. As well, the client needs to be briefed on the fact that it is possible an IRS agent might come to different conclusion, especially in cases that move closer to the single triple net lease situations.

That is, there simply is no "bright line" test for what is a trade or business. The U.S. Supreme Court rejected the suggestion that such a bright light should exist in this area. The matter always depends on the facts and circumstances of the situation, which means advisers have to exercise their professional judgment in applying the general *Groetzinger* rules to their specific facts.

The proposed safe harbor in Notice 2019-07 needs to viewed as just one tool that can, but does not have to, be used in determining if there is a trade or business. The Notice added a tool, but it did not remove any tools that we were able to make use of before the final regulations.